RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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February 11, 1981 **LETTER 802**

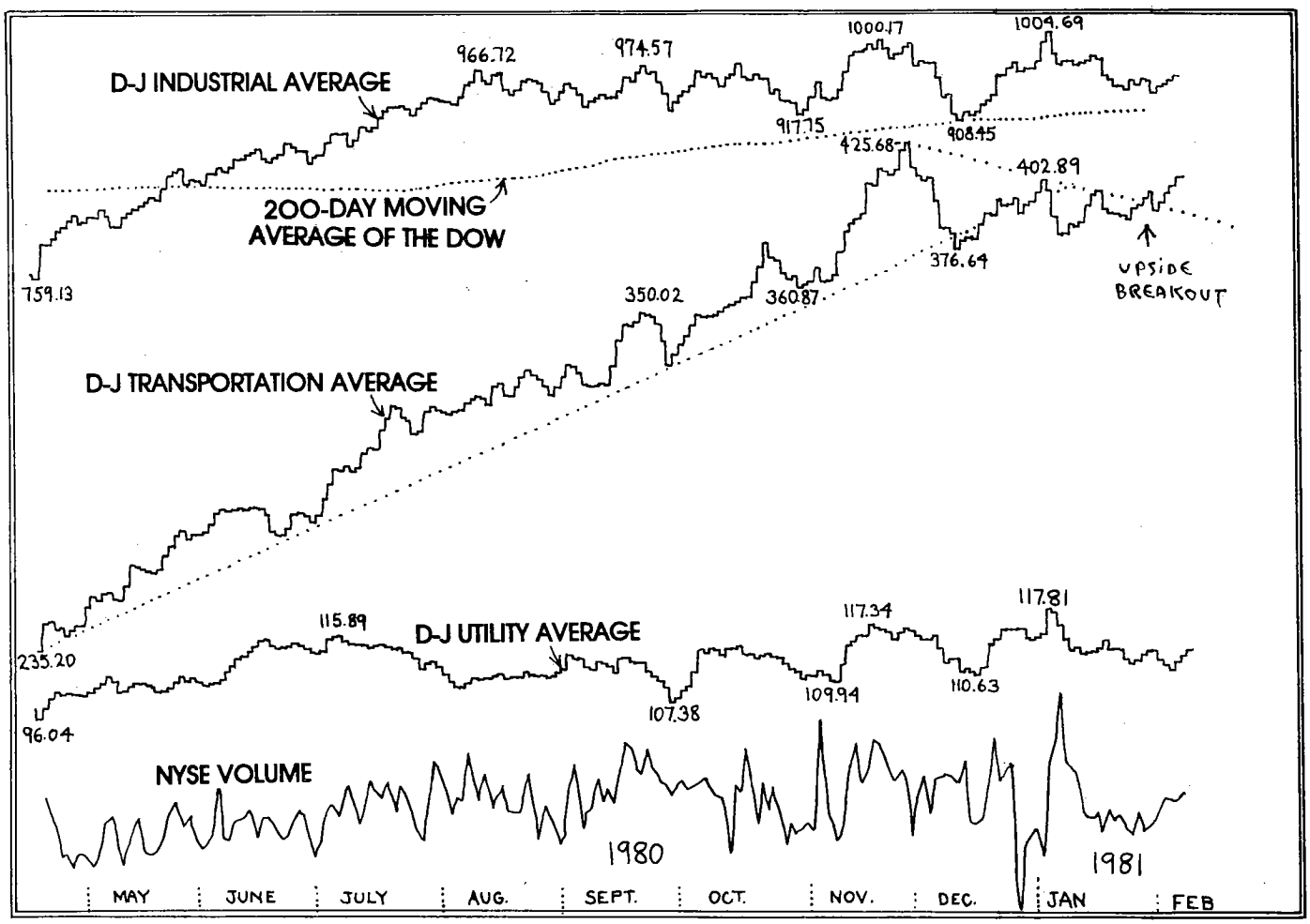
Jan. 30, DJIA 947.27; PTI 1401; A-D Ratio –18.24
Feb. 6, DJIA 952.30; PTI 1415; A-D Ratio –17.83

EASY SO FAR: President Reagan's speech on February 5 was a good one. He told the people we had inherited the *"worst economic mess since the Great Depression"* and that he has plans to do something about it. Without question, Reagan communicates to the people. But that's the easy part. What I want to see is how Reagan communicates to Congress! Reagan dwelled on the benefits of the tax cuts (they're easy). He did not dwell on the budget cuts, although he did say he'd get to them later. Reagan also said that the budget cuts would not hurt the needy. But if we're really going to bring the budget under control, believe me, the cuts will have to hurt EVERYBODY! Pardon me if I remain skeptical, but let's remember one thing. The new Administration isn't pretending to cut new spending. They're only trying to cut something off the rate of rise in Federal spending (actual spending will be way UP this year).

FACTS: On the fact front, what I've been writing about for two years is now beginning to surface. On January 28 Treasury Secretary Regan requested "with great regret" that the Federal debt ceiling be raised a full $50 billion to $385 billion. At the same time, it was announced that the Treasury will be borrowing a record $36 billion in new money this quarter (three months ago the estimate was $18 to $22 billion). The previous record was $29.5 billion borrowed in the last quarter of 1980 (wasn't that just a few months ago!).

Meanwhile, it was announced that the Federal deficit for December was a whopping $7.5 billion, while the deficit for the first three months of fiscal 1981 was $33 billion. At this rate, the total deficit for 1981 could go OVER $100 billion! To put it mildly, the finances of the US Government are totally out of control and moving to outer space!

I have reason to believe that highly placed people in the Administration read this report, and for that reason I want to repeat the following: for two years I have been warning that the relentless build-up in US debt is putting this nation in a precarious position. That position can be described as "INFLATE OR DIE." The debt of this nation is now so huge that it can only be handled by more inflation. Yet President Reagan was elected on a platform of (among other things) halting inflation. This is the great and tragic paradox of today. Reagan must strive to stop inflation. Yet to halt inflation is to face the crisis of the debt. For just as continuing inflation makes all debt seem smaller through time, deflation makes all debt seem larger – and quickly.

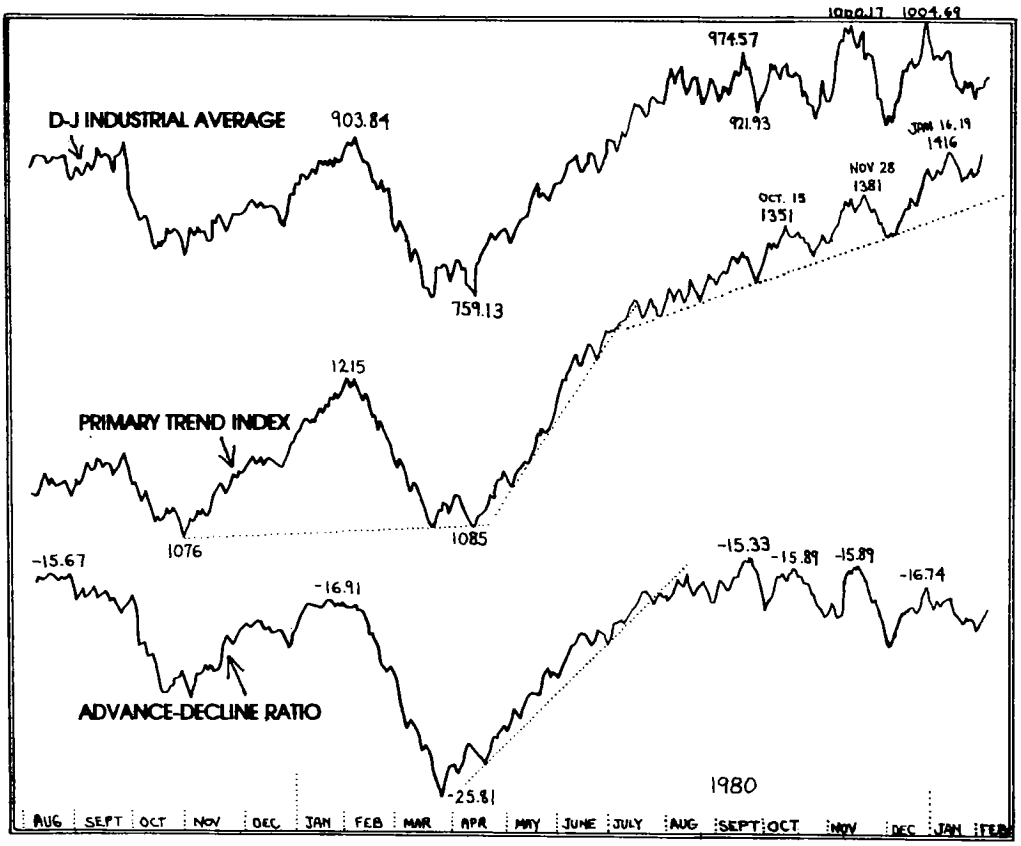


What can the Administration do in the face of the "inflate or die" situation? I firmly believe that it should do the morally right thing, and the morally right thing is to balance the Federal budget AS FAST AS POSSIBLE while probably even running a surplus (the only way out of this mess is to run surpluses). That would mean deflation, but there is no other way. To continue on the path of inflation will mean a steady eroding of the underpinnings of the economy until within a few years we will face a collapse of historic, breath-taking proportions. Ending inflation is right, and the people will accept it IF THEY ARE TOLD THE TRUTH.

I'll be honest: I have grave doubts about whether Congress will take the needed steps (even if they are proposed) to balance the budget and end inflation. I think the stock market now senses this. I think the money market now senses this. If so, it will be the MARKETS THEMSELVES that will ultimately end inflation. How will that happen? It will happen with an interest rate spike that will shock the world!

THE MARKET: There isn't anything definite you can say when the Averages are traveling in that "no man's land" between the last highs and the most recent secondary lows. And we're in that territory now. The last highs for the Averages were 1004.69 (Industrials) and 425.68 (Transports). You can see this clearly on the page 1 chart. If BOTH Averages better those highs the bull market will be reconfirmed. The last secondary lows were 908.45 and 376.64. If BOTH Averages drop below those lows a primary bear market will be signaled.

Neither action has occurred yet. That's the "non-story" in the Averages. Nevertheless, according to Dow Theory a trend is taken to remain in force until PROVED OTHERWISE. Therefore, despite all spurts, drops, jerks, and swoons, the bull market in stocks is conceded to remain in force – unless 908.45 and 376.64 on Industrials and Transports are violated. And that's not looking likely now.



Observation: The Transportation Average (see page 1 chart) has now bettered preceding minor highs. It has turned strong enough so that if I were a bear and short on the market, I would be sweating. In view of recent Transport action, I don't see the possibility of a Dow Theory bear signal any time soon. Time is running out on the bearish camp.

PRIMARY TREND INDEX (PTI): At times I feel like Dr. Frankenstein, having taken a number of items, worked them together, and then producing a monster that I can't control. It would be lovely if the PTI had a habit of fitting in with my own preconceived notions – but the PTI doesn't oblige me or anyone else. It has a life, and a method of functioning, that is all its own.

Many years ago (1968) I realized that no single indicator or device would give me the answers I needed in the stock market. Even more discouraging, no single device would (with real consistency) identify the underlying trend. In frustration, I began experimenting with various indicators and devices in the hopes of coming up with something new, something that would solve the great market dilemma for me. Finally, through deduction as well as trial and error, I put together the PTI, a device that was both logical and which held promise.

But I had one great problem with the PTI. And that problem was simply – no history. I decided that it would require a decade of action before I could (1) learn to read the PTI, and (2) have a record that would prove, or disprove its usefulness and accuracy. As of now. I've seen the PTI operate in periods of stagnation, through a great bear market (1973-74), through a bull market (following 1974), and through periods of price-breadth divergence and confusion (as in the present). My conclusion is that the PTI is a remarkable stock market instrument.

My friend, Joe Granville, in his January 3, 1981 report writes, *"This market is out to destroy all those who refuse to look at everything, those who love to swing on a few branches of the market tree of indicators. It will destroy those who follow just the specialists, it will destroy those who follow the so-called 'insiders,' it will destroy those who put all their faith in the A-D line, and effectively has destroyed all those who follow such irrelevant things as earnings, dividends, and interest rates (the things followed by economists and bank trust officers.'*

I thoroughly agree with Joe. And it was this kind of thinking that led me to my original work on the PTI. In view of all this, let's study the action of the PTI. In March, 1980, following a violent drop, the PTI turned up. The PTI held above a steep rising trendline into July. Beginning in July, the PTI walked up a shallower and more sustainable trendline, and that takes us to the present. Despite the Iranian mess, despite huge Federal deficits, despite a long list of bearish happenings, the PTI has continued to hold in a bullish phase – above that rising trendline.

During January, 1981, the action of the PTI was even more dramatic. Despite a sharp drop in the Averages and

the general market, despite the biggest volume selling day in NYSE history (Jan. 16), the PTI continues to hold above its rising trendline. Thus, the PTI states that the trend on the NYSE continues bullish.

I've said many times before, and I'll repeat, the market cannot fall apart as long as the PTI holds in a rising trend. As of this writing, the PTI continues to hold above its long, rising trendline, and despite warnings and "sell signals" from many prominent analysts, this market has not yet fallen apart.

The fact is that since September, 1980, technical divergences and non-confirmations have been evident. Note on the chart that the A-D ratio for the NYSE topped out on September 19. Since then it has traced out three descending peaks, and this is normally a danger signal. My 5-day average of daily new highs peaked on November 19 at 202, then hit a secondary peak on January 6 at 79. At present, new highs are running in the 40-60 class. Furthermore, the major composite Averages (NYSE, S&P, D-J 65) topped out in November. All of this has occurred, but the market still has not disintegrated. Why?

My only answer is that the PTI, in holding stubbornly above its rising trendline, has said, "This market may have its troubles, but the weakness has been spotty and unconvincing so far." Now study the latest PTI action on my daily chart. The PTI hit a high of 1416 on January 16. It backed off to 1388, then started up again. As last week ended (week ending Feb. 6) the PTI was within easy striking distance of its high again!

That's upward technical pressure and bullish for the market – and it flies in the face of wide-spread public pessimism, high interest rates, all kinds of well-advertised "sell signals" and dire predictions on the fate of the market. So it is best to remember that the PTI (in its own relentless way) reflects internal market action – not your expectations or mine. And after all, if the PTI did only the obvious, what use would it be to us?

INVESTMENT POSITION: Forgetting all news events, scary headlines and assorted dismal business statistics, the Averages and the PTI indicate that you can continue to sit with mutual funds or stocks – no bear signal has arrived as yet. For that matter, I feel that time is running out for the many bears.

For those who wish, I would now suggest positions in top-performing mutual funds such as *Guardian, Dreyfuss Number Nine, American Investors Fund* or *Fidelity Equity Fund.* All this on the express stipulation that they be held only as long as the PTI remains in its bullish mode. But bullish it is, and who knows where this advance could go.

At this time, I personally feel at ease with a good major part of my assets in 91-day Treasury bills. At yields above 14%, the bills provide a "real" return, and that together with their undisputed safety makes them a very attractive vehicle to me.

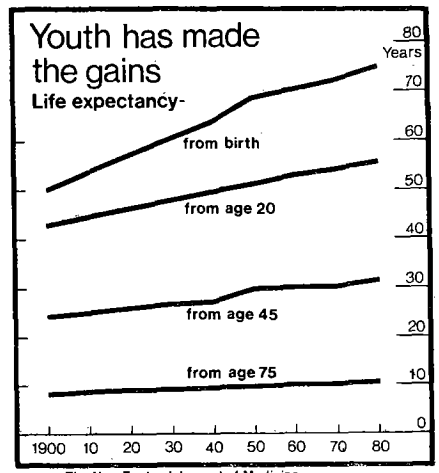
NOTES & QUOTES: In my opinion, "supply economics" is the bunk and is just a euphemism for more inflation. I've said before and I repeat, cutting taxes is easy, cutting spending is hard. My own feeling is that tax cuts don't get through Congress, Federal deficits are going to rocket out of sight. Tax cuts do not guarantee an increase in prosperity, but failure to reduce the budget guarantees financial chaos.

* * *

The MX missile is finished, and there is a high probability that the B-1 bomber is an idea whose time has passed (see last Letter). The Administration now wants to go a way it can afford, the neutron bomb. This would be a cheap program, very cheap compared with the MX or B-1. And that's why it will probably materialize. I think it's a good idea.

* * *

Despite all the misconceptions about modern man's increased life expectancy, the only major gains in life expectancy have come for the dramatic improvement in birth techniques. This chart (from the Jan. 10 *London Economist*) shows the improvement rate (gains in life expectancy) in the various age groups since 1900. Note that at age 75 there has been almost no improvement since 1900. At age 45 there is a bit of improvement. At age 20 there is some improvement. But the real improvement is from birth, and this birth improvement pushes the overall average up.



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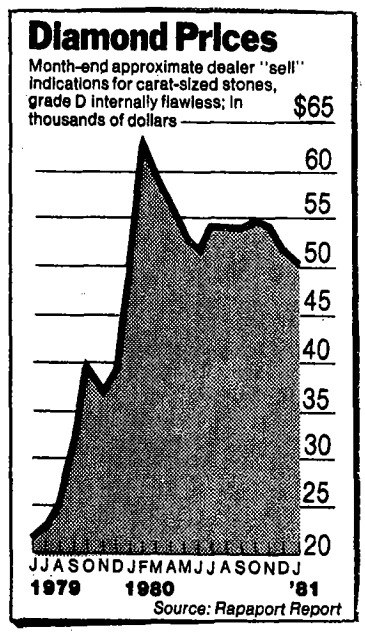
Diamonds may be a "girl's best friend," but they have not been an investor's best friend over the past year. A one-carat flawless stone that sold for $65,000 last year (wholesale) now sells for $52,000 or less. Softness has shown up in other collectible items such as stamps and coins. Can art be far behind?



Two things have occurred. Prices on collectibles have been bid up too high and too fast. And cash now commands mouth-watering returns. In the face of this comes the tumble in collectibles.

One uncomfortable possibility may lie ahead: inflation continues in basic items such as food, rent and manufactured items, even while deflation continues in the so-called "store of value" collectibles. The most important item of all, houses, remain in a fuzzy trend. Many middle to lower-priced homes are down as much as 18%. But the larger homes in the more wanted areas continue to draw top prices.

* *

Finally someone is noticing the compounding rise of interest on the national debt. In the Feb. 9 issue of *Business Week*, an article appears entitled, "Interest is Eating Up The Budget." The article notes that since 1974, Education, health and human services are up 121%, defense spending is up 71% and interest on the Federal debt (are you ready for this) is up 156%. As I was saying, compounding is the eighth wonder of the world. And when you compound what you owe (rather than compound what you save)

you're heading for bankruptcy!

* *

We've always had a large number of Canadian subscribers. And they've been calling lately, complaining about mail delivery. OK, US mail delivery is nothing to boast about, but Canadian delivery is the pits. It's not my fault, I can't do anything about it, I'm sorry. Please, put the pressure on the Canadian post office – all mail goes out of here every other Wednesday via Air.

* *

Lauren Russell is 7 weeks old, fat and healthy. To my mind, one of the greatest advances in medicine of the past 20 years has taken place in the treatment of new-born babies. Now babies are treated like human beings, breast fed, kept with their mothers (in modern hospitals, that is). I have always felt that the old sanitary "stick 'em in the nursery" syndrome was a psychological disaster. The reason it was done that way is that for centuries all doctors were men. And no man ever had a baby, no man ever suckled a baby, no man ever possessed a maternal instinct. Thus, doctors until now have treated child birth like a surgical operation, they treated new born babies like white mice, and they treated breast milk like poison. There, I said it (and I'm entitled, having had kids over a quarter of a century – from 24 years old to 6 weeks old).

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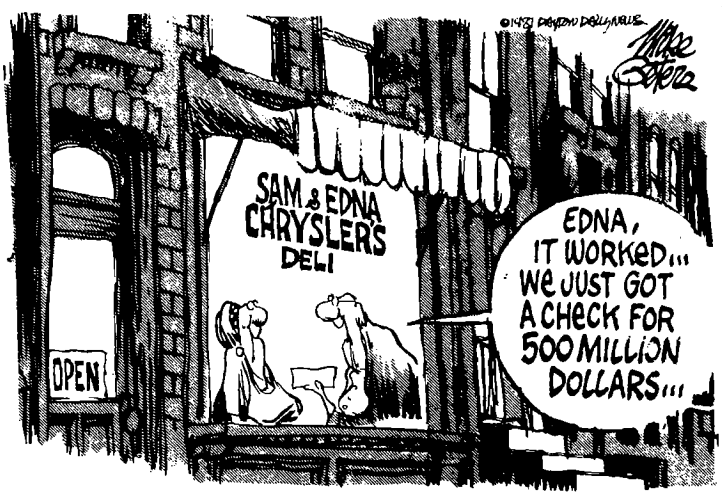
Federal spending has become so ridiculous that even the cartoonists are finding it a subject for their pens. As note below:



READERS ASK: Question: You speak of the inevitability of deflation in which prices will fall and cash will become valuable. But it is my impression that none of the important world inflations have, in fact, ended this way. In post WW I Germany, for example, prices kept rising and the market did not regain its purchasing power. The same happened with France's slower inflation. Similar patterns happened in Mexico and elsewhere. Do you feel that something different will happen in the current inflation? Why? (Dr. J.W.H., San Francisco).

Answer: I think there is a good chance something different will happen before this is all over. And the reason is that this time the world (and particularly the US) have built a massive pyramid of debt. This debt must be sustained, interest must be paid on it. The debt is rising on a compound basis, and the only way this debt can be serviced is if cash flow and earnings rise on a compounded basis. This is not occurring.

I don't think one out of a thousand Americans has any idea of the debt-monster we have built over the last 40 years. This tabulation (courtesy of *Money and Markets*, Box 2923, W. Palm Bch, FL 33402) should give you some idea of the situation. Today the total US debt is around $4.5 trillion. That means that at average rates of 12% the debt structure requires $540 billion a year to sustain it or $45 billion a month. The thing that has been holding the debt structure together so far has been inflation. Cut the rate of inflation down, slow business down, and there is no way the current $4.5 trillion debt can be serviced. And that is the dilemma that no economist can deal with (most don't even understand the problem!).

Table 1. TOTAL DEBTS OUSTANDING IN U.S.

(billions of $)	12/31/79	9/30/80
U.S. Gov't Sec.	916.7	1000.4
State & Local Debt	312.7	329.3
Corporate Bonds	455.7	488.5
Mortgages	1333.7	1421.7
Consumer Debt	382.3	374.6
Bank Loans	406.8	432.7
Open-Market Paper	156.5	176.6
Other Loans	281.6	301.6
TOTAL	4246.0	4525.5

data: Federal Reserve

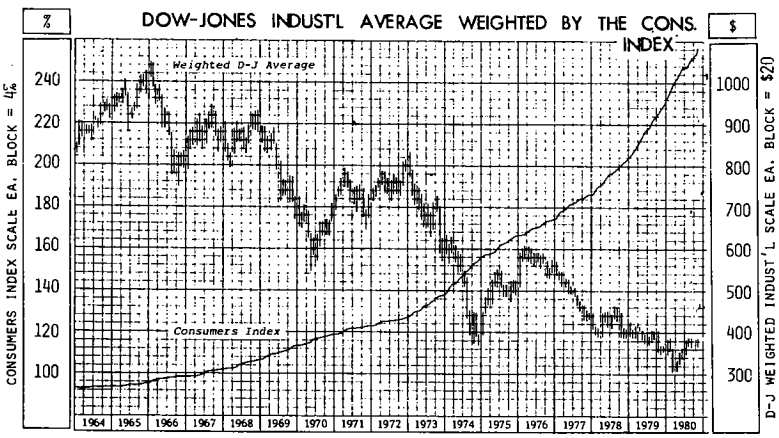
This means at some time in the future (probably within a few years) the US and many of the nations may have to renege on the debt or change the terms. If this happens, shock waves will spread out across the world. Those shock waves will be deflationary (since vast amounts of liquidity will be destroyed as the debt goes under). Rising debt and rising costs of servicing debt is *deflationary*. Only rising inflation can handle the debt, and the world is now trying to hold back inflation. Thus the debt and counter-inflationary desires are at odds. The results will ultimately be explosive. We are seeing minor explosions in the money markets and in interest rates NOW.

Question: I see how you could draw many sound conclusions from price changes in the Dow Jones Averages if these changes were measured in dollars of constant purchasing power. But with the dollar losing its real value, how can you continue to draw the same sort of conclusions as if it were retaining its value? If the Dow hits an all time high, doesn't this have quite a different significance depending on whether it is, or is not, at an all time high in terms of actual purchasing power? If an asset of mine

goes to new highs in purchasing power I am very pleased. But if it only goes to new dollar highs while declining in purchasing power I cannot take much satisfaction.

Answer: The D-J Averages were never designed to be a measure of purchasing power. The Averages represent the markets appraisal of the value of 30 major American companies. I include here a monthly chart showing the Dow adjusted by the Consumers Price Index. You can instantly see that the peak was hit in early 1966, and it was no coincidence that the great bull market which began in 1949 ended in February, 1966.

It is my opinion (and that of most Dow Theorists) that the Averages adjust for EVERYTHING including inflation. The current issue of *Forbes* contains an article on corporate cash flow. *Forbes* found that a great many major companies have actual negative cash flow. They are paying out dividends when they have no right to. The market recognizes this, as it also recognizes phoney earnings reported to bolster the price of the stock. These



are some of the reasons why the Dow topped out in 1966 and has never been substantially higher. No, the Dow does not measure inflation, nor does it go up with inflation. The Dow goes up when buyers move into those stocks on the basis of those stocks being good investments. On balance, the big Dow stocks have been poor investments. They have not fared well since 1966 and thus the Average has never appreciably bettered the 1000 level. (Dow chart courtesy of *Horsey*, Salisbury, MD 21801).

MONEY RATES: Lord knows how much money has been lost over the last six months "bottom fishing" for bonds and other money instruments. I'm not fishing. I continue to advise staying with the 91-day Treasury bills. I continue to advise against trying to catch the great, elusive top in interest rates. I don't think we're at the top (in rates) yet, and patience is all that is needed.

Money supply (M-1) is now dropping, and who knows, this could mean a cash squeeze. At any rate, interest rates firmed last week– this despite a decline in Fed Funds to the 17% area (they had been in the 20% area). Thus, the rates are not responding to the decline in Fed Funds, a rather unusual occurrence suggesting pressure from somewhere else.

Sometimes I think that all my efforts would be worthwhile if I could just teach people that there is a difference between investing and trying to get your excitement in the markets. Most people (unconsciously) are looking for excitement – or they are trying to prove something ("what a genius I am"). As I've said so often, making money is often boring, as boring as doing nothing for a while. In the money markets, try doing nothing; just collect that fat interest on your bills and leave the fancy footwork to the amateur, in-and-out traders.

FOOD SURVIVAL: I have been wanting to write this little piece for some time so here goes. The piece is on staying alive longer by eating correctly. Since I love all my subscribers and I want them to remain alive as long as possible, I am going to write a brief article which condenses what I've learned about good diet through a solid 10 years of reading and self-experimenting.

First, Americans for the most part eat wrong. They eat far too much (animal) fat, far too much sugar, far too much salt. On the other hand, they take in far too little fiber (vegetable roughage). Books have been written on the bad effects of high meat and fat diets, high sugar, high salt. Believe me, those books tend to be correct. I'm going to give you a super-concentrated course in eating right – as follows:

(1) Avoid processed flour, eat whole wheat breads, brown rice, any and all vegetables. Avoid dairy products as much as possible (almost all have high animal fats) except non-fat milk is fine. My breakfast consists of shredded wheat, non-fat milk, bananas. Read labels on all wrappers. Avoid if possible the foods with fats and if possible avoid all white flour products. The white flour and white rice have had the fiber removed. The fiber is what moves the food rapidly through your intestines and out. The longer the food stays in your intestines, the more calories you absorb and also the more likely you are to become constipated.

(2) Eat as much in the way of vegetables as possible. Vegetables contain no cholesterol, most contain fiber, and most contain plenty of vitamins. Elephants live entirely on vegetables and NO meat, and elephants have plenty of strength so meat is not necessary. The preferred "meat" is chicken (with skin off) and fish. Both are low in animal fats and cholesterol. Do not fry your food.

The best bread that I have found is the Pita bread (Lebanese bread) sold in most health food stores. It is made of whole wheat, water and salt, nothing else. If you have to eat hot dogs, try chicken hot dogs. They taste the same and contain no beef.

(3) You can stay thin and eat your head off if you stay basically with vegetables, whole wheat, fruit (any kind) whole wheat pita bread, whole wheat products. If you have to eat a frozen dessert eat ices (ices are made without any milk or cream, sherbet is made with milk rather than cream. Ices are preferable to sherbert and sherbert is preferable to ice cream.

(4) Salad is dietetic if you use a salad dressing devoid of oil. You can buy powdered health dressing in a health food store, then add vinegar and water – forget the oil.

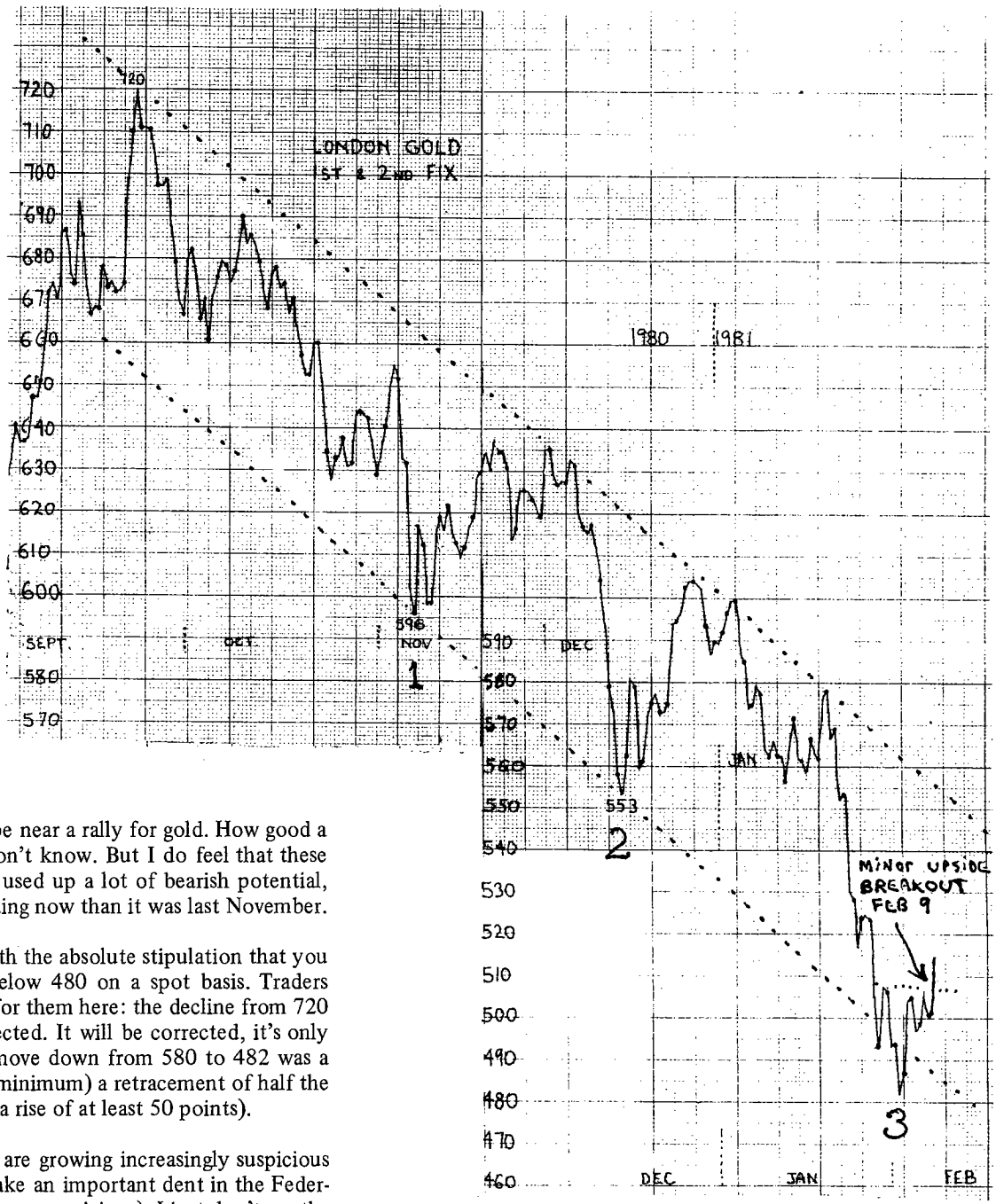
(5) Fats, sugars and salt are all American *habits*. You can do without them just as you can do without cigarettes. If you avoid fats, sugars and salts within a few months you will lose your urge to take them in – and you will be very much healthier.

(6) A good supplement for those who have fat problems (high cholesterol) is as follows: mix a batch of ¼ lecithin, ¼ raw wheat germ, ¼ brewers yeast and ¼ bran. Each day put two tablespoons of this in a blender, add some orange juice, blend and drink. In three months, you should feel the difference. So don't think about getting healthy, dear subscriber – do it!

GOLD: "Gold, gold, you're making me old." I'm just kidding, of course. In the last few Letters I stated that gold has been moving down within a descending channel as shown on the chart. I said that it is normal for the bearish potential to be exhausted in

three downward thrusts. It seems to me that we are about there now.

This chart shows the first and second London fix for gold (daily). The extreme low, so far is the 482 morning fix of last week. There are a few things worth noting about the current gold picture. (1) The low fix came just about on the bottom channel trendline. (2) The low fix came during the third downward thrust. (3) The declining channel has been in existence ever since September (five months), a long time for a declining trend. (4) Pessimism regarding gold is now rampant, and you hear expressions in board rooms such as "It's going to 250 or 350" and "It's finished." (5) A little bottoming pattern is now showing on the gold chart.



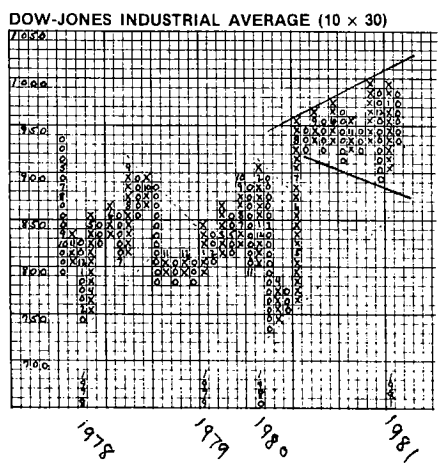
I would guess that we could be near a rally for gold. How good a rally, how far a rally, I just don't know. But I do feel that these three downward thrusts have used up a lot of bearish potential, and gold is a lot more interesting now than it was last November.

For traders: buy gold here with the absolute stipulation that you sell positions if gold closes below 480 on a spot basis. Traders have an important plus going for them here: the decline from 720 to 482 has not yet been corrected. It will be corrected, it's only a matter of when. Also, the move down from 580 to 482 was a panic move. I would expect (minimum) a retracement of half the panic decline (in other words, a rise of at least 50 points).

Finally, I believe the markets are growing increasingly suspicious of Congress' willingness to make an important dent in the Federal budget (I know I personally am suspicious). I just don't see the politicians doing anything until their backs are against the wall. And I don't believe their backs are against the wall now (frankly, I don't get a sense of "emergency resolve" from the Reagan administration on budget slashes, and I'm talking about, major, whopping, meaningful budget slashes.

LATE NOTES: PTI closed at 1415 on Feb. 6. That's just a point below the high of 1416! Any strength this week will take the PTI to a new record high. Go fight it; there's just no weakness in the PTI, and that's good for the bulls and bad for the bears. If the PTI continues to climb, somewhere along the line we're going to get a short squeeze and maybe a surprise on the upside.

NEXT MAILING: FEBRUARY 25



EXTRAORDINARY broadening formation as seen on a point and figure chart of the Dow. The chart implies great indecision on the part of the market, but it is not necessarily bearish (the popular opinion of a broadening formation is that it is bearish). Chart courtesy of Chartcraft, Larchmont NY.